Federal 2022 Budget – Update

Economics and Strategy

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Ottawa shows stronger fiscal hand, though downside risks mount

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Summary

As the global economy and financial markets contend with ongoing tumult, Finance Minister Chrystia Freeland and the minority Liberal government offered a fresh take on Canada's economic and fiscal prospects. To be clear, what we've been presented amounts to an update, not to be confused with a mini-budget. Notwithstanding elevated risks of a Canadian (and global) recession, the underlying fiscal backdrop is meaningfully improved relative to a budget plan set down in April 2022. (Sound familiar? That was the story in the update to Budget 2021, with countless provincial fiscal tallies also flagging better-than-planned results.) We're not talking chump change here. The cumulative deficit through 2026-27 looks to be roughly $60 billion smaller than was envisioned just seven months ago, including a 'baseline' path to balance that has now been paved (even if it's still five years away). Skinnier deficits (on a backward- and forward-looking basis) mean debt needn't grow as much as previously thought. Meanwhile, higher-than-expected nominal GDP is also helping to quickly repair relative indebtedness. Debt-to-GDP, which was thought to have been 46.5% last year and was expected to decline to 41.5% by the end of the forecast horizon has: (a) an improved starting point (45.5% in 2021-22) and (b) a much-improved end point (37.3% by 2027-28). That, as the Government of Canada will proudly tell you, is consistent with the finest general government net debt burden in the G7, not that competition there is the toughest. Critically, it's times like this when low debt burdens matter, as a growing interest bill will increasingly consume government income. The Canadian government is far from immune, but suffice to say, it could be worse. While revenues are higher and deficits lower, the government couldn't help itself from spending a touch of their unexpected riches (i.e., above-plan revenue). In the FES, titled *'Building an Economy That Works for Everyone'*, you'll find some marginal, and critically, targeted support for low-income Canadians (e.g., student debt relief, GST benefit enhancements). And in line with government environmental priorities, there are new tax credits available to businesses who invest in clean energy/technologies. There are some marginal revenue sources too, as the FES signals an intention to follow in the footsteps of the United States and implement a tax on share buybacks. While the FES assumes a very slow growth environment in the year ahead, the government concedes that a recession is well within the realm of possibilities and accordingly provides a 'downside' fiscal outlook. Such a scenario would of course jeopardize the path to balance, but longer-term indebtedness wouldn't really be any worse than they'd thought back in April. Finally, the Debt Management Strategy update reflected the firmer fiscal footing as T-bill and bond supply targets have been cut by roughly 10% from prior guidance. It was a balanced reduction across the curve, though it's worth noting the government opted to scrap its Real Return Bond program. Refer to page 3 for debt management details.

Selected highlights

- **Economic outlook**

  Since 1994, the average of the private sector economic forecasts has been used as the basis for fiscal planning. The survey was conducted in September. Reflecting the elevated probability of a recession, the Fall Economic Statement present a baseline and a downside scenario. Key elements of these forecasts include:

  - **GDP** – Given persistent global supply chain issues, the conflict in Ukraine, high inflation and rising interest rates weighing heavily on household and business finances, real GDP growth in Canada for 2022 has been revised down from 3.9% in the budget to 3.2% in the baseline scenario case. In stark contrast with the 3.1% initially forecast in the budget, 2023 growth is expected to grow at an anemic 0.7% in the baseline scenario and could even decrease by 0.9% in the event of a recession. However, the recession in this downside scenario appears to be short-lived and of low intensity. For 2022 and 2023, the baseline growth outlook is largely in line with our own forecasts. Further out, real GDP is projected to increase by an average of 2.1% between 2024 and 2027 in the baseline scenario. Nonetheless, by the end of 2026, the level of real GDP is expected to remain about 2% lower than budget 2022 projections. On the bright side for the public finances, nominal GDP has been revised sharply upward in 2022 from 8.0% to 11.8%, driven by higher-than-expected inflation and increases in the price of several commodities. However, the expected slowdown in 2023 has reduced the nominal GDP forecast from 4.8% to 2.6% under the baseline scenario and to just 0.9% under the downside scenario. Thereafter, nominal GDP is projected to increase by an average of 4.0% from 2024 to 2027 in the baseline scenario.
  - **Labour markets** – The unemployment rate projection for 2022 has been revised down from 5.8% to 5.4%. However, given the less favorable economic outlook for the coming year, this is expected to increase to 6.1% in 2023 and 6.2% in 2025 under the baseline scenario (vs. 5.5% in the budget). In the downside scenario, that would climb to 6.6% in 2023 and 2024, though such an increase in the unemployment rate remains fairly modest compared to the financial crisis of 2008 when it reached 8.7%. Thereafter, the unemployment rate in the baseline scenario is expected to gradually decline from 6.0% in 2025 to 5.7% in 2027.
  - **Interest rates** – Given the increasingly restrictive monetary policy being set by the Bank of Canada, the outlook for Canadian T-bill rates were revised significantly higher, by 140 bps in 2022 and 70 bps in 2023, leaving us with this short-term rate at 2.2% in 2022 and 3.6% in 2023. The update then projects bill yields to be 2.8% in 2024, 2.3% in 2025, 2.1% in 2026 and 2027. Out the curve, 10-year yields

have been revised up as well. It sees rates at 2.8% in 2022, 3.1% in 2023, 2.8% in 2024 and 2025, 2.9 in 2026 and 3.0% in 2027. Clearly, given where rates currently trade, risks here are skewed higher.

Fiscal outlook

As noted above, the FES arrives at a transitional moment for the Canadian economy, with slower growth set to take hold as aggressive monetary tightening works its way through the system. For the time being, however, we continue to receive predominantly positive fiscal news from Canadian governments, owing to a stronger-than-expected glide path for nominal GDP. That trend was well in evidence here, the underlying revenue outlook boosted a cool $40 billion vs. budget.

In one form or another, Ottawa has committed a portion of the 'bonus' revenue to new measures, the newest of which are (not surprisingly) focused on 'making life more affordable'. The resulting budget deficit for 2022-23, at $36.4 billion amounts to a relatively contained 1.3% of GDP. The updated deficit tally represents a non-trivial improvement vs. April's budget, where a shortfall of $52.8 billion was forecast, and further extends the federal government's overall fiscal recovery. Reference note: At the peak of the pandemic, economic disruptions and extraordinary government supports saw the federal deficit swell to $327.7 billion. The deficit was knocked down to $90.2 billion by 2021-22 as the recovery started to take hold.

The medium-term fiscal outlook sees the positive revenue base effect carrying over, notwithstanding an expectation of slower growth ahead. With positive net adjustments more than offsetting new commitments, the FES flags progressively smaller deficits for each fiscal year, culminating with a $4.5 billion surplus in 2027-28 under the baseline scenario. Detailed year-by-year comparisons to April's budget reveal an average budgetary upgrade of $10 billion a year. Put another way, the cumulative deficit (to 2026-27) is now $60 billion lower than that envisioned in April, which means less federal debt than previously telegraphed (in the here and now and longer term).

Combining smaller deficits with an upgraded level of nominal output could make for nifty progress on the federal debt-to-GDP ratio, which remains the government's stated 'fiscal anchor'. This closely watched metric is slated to end 2022-23 at 42.3% vs. the 45.1% level pledged at budget time. The baseline scenario implies only limited progress on debt-to-GDP in 2023-24 before regaining more meaningful downward momentum in the out years of the plan (e.g., debt-to-GDP reaching 37.3% in five years from now).

Interest rates have moved up quickly/significantly, and that means a growing interest bill for governments at all levels. For Ottawa, public debt charges are projected to grow by at an average annual rate in excess of 10% through 2027-28. That's more than double the corresponding growth rate for revenue, meaning the federal 'interest bite' will increase from an admittedly low level. Specifically, the interest-to-revenue ratio is seen peaking at 9.4% in 2023-24 vs. the 5.9% level notched in 2021-22 before central banks got rolling on rate hikes. This measure of debt affordability remains comfortably below the levels registered from the 1980s right up to the GFC.

In light of elevated uncertainty, and reflecting today's gloomier economic mood, a 'downside scenario' has been detailed, wherein current and future year budget balances are weaker to the tune of $13-22 billion/year. In this slower growth scenario, the return to balance would be delayed beyond 2027-28, all else equal. Of note, the adverse scenario presented in the FES would involve a temporary setback in debt-to-GDP in 2023-24. This ratio would nonetheless remain on a downward trajectory over time and would look little changed vs. April's budget plan, which is a clear nod to the much-improved starting point.

The FES takes the opportunity to remind stakeholders, including bond holders, that Canada possesses the lowest net debt-to-GDP ratio in the G7, with fresh IMF forecasts suggesting that Canada's fiscal edge could well grow from here.

New measures

Today, the government announced a total of C$6.1 billion in additional spending for new measures this year alone that had not been included in the budget. Overall, the government plans to spend an additional C$30.6 billion through 2027. The new measures were centered around three axes:

- **Making Life More Affordable:** Significant announcements in this area have been made in recent weeks, including the doubling of the GST tax credit for the next six months (C$2.475 billion), the new national dental program and the $500 to top-up the Canada Housing Benefit to low-income renters (C$1.1 billion). Among the new measures not already announced, Ottawa will now allow to issue automatic advance payments three times a year for the Canada Workers Benefit, instead of a single payment at the time of the tax declaration (C$3.945 billion). The FES also makes permanent the suspension of federal interest charges for student and apprentice loans (C$2.787 billion). A suspension had previously been in place until 2023. The FES also includes a C$1.3 billion amount for the rebuilding of Atlantic Canada and Eastern Quebec after hurricane Fiona.
- **Jobs, Growth, and an Economy That Works for Everyone:** The main component in this section of the FES is aimed at securing Canada's competitiveness and creating good jobs for workers. To achieve this, the government is proposing the introduction of a new refundable tax credit of 30% of the capital cost for investment in clean technologies (C$6.65 billion).
- **Fair and Effective Government:** The main measure included in this section is the introduction of a new 2% tax on the net value of all types of share buybacks by public companies in the country (+C$2.12 billion). The details of this new tax, similar to what has been implemented in the United States, will be announced in the next federal budget.

Update to the Debt Management Strategy

What does the Government's revised fiscal outlook mean for the sovereign's borrowing plans for the balance of the year? Bear with us as we walk through some important takeaways from the *Debt Management Strategy* Update, presented as an annex to today's FES.

- The government revised down its end-of-year target for outstanding Treasury bills from C$213 billion in the Spring DMS to C$192 billion today. That's just C$5 billion higher than where the bill stock stand today and implies that T-bill auction sizes will remain at C$16 billion for the balance of the fiscal year.
- Meanwhile, the C$212 billion in gross bond issuance signaled in the April DMS has been revised down to C$191 billion (-10%). Based on numbers presented here, fiscal second half (Oct-22 to Mar-23) gross bond issuance should come in at $90 billion (including a $5 billion green bond issue), following just over $100 billion in the first half of the year.
- Relative to April's DMS, issuance plans have been trimmed modestly across the curve to accommodate the lower overall program size. That will also mean lower target benchmark sizes. Today's signalled cuts are in addition to the ultra-long bond cancellation earlier in the year. That cancellation technically pulls down the weighted average term of issuance from 7.7 years as planned in Budget 2022 to 7.0 years today, but this is well in the rear-view mirror by now. None of today's marginal adjustments to issuance plans should have an impact on yield curve technicals. It's worth noting however, that 10-year and 30-year issuance remain well above the pre-COVID run rate, while 3-year and 5-year borrowing plans are effectively in line with the totals in the 2019-20 fiscal year (2-year supply is still about 25% higher). So, while rapidly rising rates have made the 'term-out' less compelling and has led to issuance duration shortening from its peak, new bond supply is still materially longer in term than under the ultra-short-term borrowing program that prevailed in the late-2010s.
- Say goodbye to real return bond issuance. In a somewhat surprising move, the government "decided to cease issuance of RRBs effective immediately". Why? The decision "reflects low demand for this product and will allow the government to promote liquidity by consolidating funding within our core funding sectors."
- The Government of Canada's second green bond issue is poised to come to market "before the end of 2022-23", with a C$5 billion face value still attached. As for the details of the bond, "Future decisions on size, tenor, and timing of the next green bond issuance will take into consideration views from market participants and the availability of eligible green expenditures." (Recall, the inaugural issue last year came with a 2029 maturity date). In addition to green bonds, the government will "explore the development of a sustainable bond framework", allowing the government to issue social or transition bonds as well.
- The update also reiterated the government's intention to issue a $500 million Ukraine Sovereignty Bond targeted at Canadian retail investors. "Equivalent proceeds from this bond issuance will be channeled into a loan, via the IMF Administered Account, to support the government and people of Ukraine".

Table: Gross bond issuance (again) below prior guidance

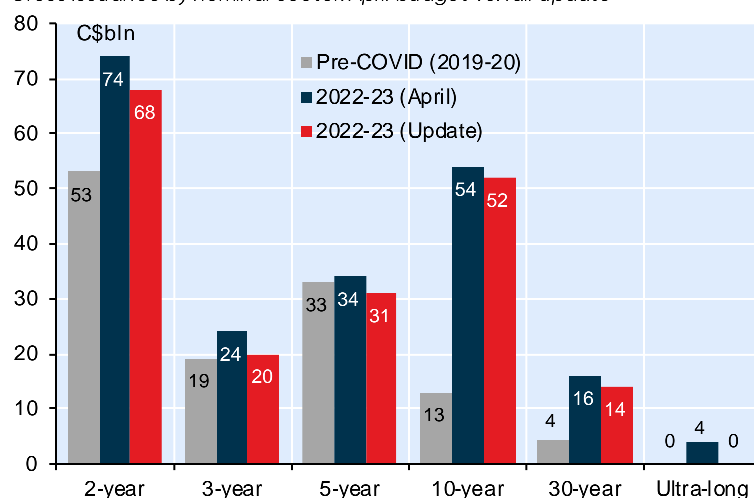
Gross issuance by fiscal year (2022-23 planned and updated for reference)

	Target b'mark size	2019-20	2020-21	2021-22	2022-23 (April)	**2022-23 (Update)**
2-year	$14-18 bln	53.0	129.0	67.0	74.0	68.0
3-year	$8-12 bln	19.2	56.5	29.0	24.0	20.0
5-year	$14-18 bln	33.0	81.5	40.0	34.0	31.0
10-year	$18-24 bln	13.0	73.5	79.0	54.0	52.0
30-year	$25-40 bln	4.2	32.0	30.0	16.0	14.0
Ultra-long	$8-12 bln	0.0	0.0	4.0	4.0	0.0
RRB	-	1.8	1.4	1.4	1.4	0.7
Green	-	-	-	5.0	5.0	5.0
Total	-	124.2	373.9	255.4	212.4	190.7
WAT	-	5.1	7.0	9.4	7.7	7.0
2Y/3Y/5Y%	-	86%	72%	55%	64%	64%
10Y+%	-	14%	28%	45%	36%	36%

Source: NBF, BoC, 2022 Economic and Fiscal Update | Note: WAT and issuance mix excludes RRBs and greens. WAT calculation uses generic term of tenor. E.g. A bond issued in 2-year sector assumed to have term of exactly 2 years.

Chart: All sectors lower; WAT remains longer than pre-COVID

Gross issuance by nominal sector: April budget vs. fall update



Source: NBF, BoC, 2022 Fall Economic and Fiscal Update

Table A1.2

Economic and Fiscal Developments, Policy Actions and Measures

billions of dollars

	Projection						
	2021–2022	2022–2023	2023–2024	2024–2025	2025–2026	2026–2027	2027–2028
Budgetary balance – Budget 2022	**-113.8**	**-52.8**	**-39.9**	**-27.8**	**-18.6**	**-8.4**	-
Impact of September private sector survey and other fiscal developments	23.6	29.8	18.8	11.0	10.2	11.4	-
Budgetary balance before policy actions and measures	-90.2	-23.0	-21.1	-16.8	-8.4	3.0	12.8
Policy actions since Budget 2022	-	-7.3	-4.3	-2.9	-1.8	-1.8	-3.5
***2022 Fall Economic Statement* measures (by chapter)**							
Making Life More Affordable	-	-4.4	-1.3	-1.3	-1.3	-1.4	-1.4
Jobs, Growth, and an Economy That Works for Everyone	-	-0.1	-2.1	-2.3	-1.8	-2.3	-2.4
Fair and Effective Government	-	-0.6	-0.8	-0.2	0.4	0.5	0.6
Provision for anticipated near-term pressures[1]	-	-1.0	-1.0	-2.0	-1.5	-1.5	-1.5
Total – *2022 Fall Economic Statement* measures	-	-6.1	-5.2	-5.8	-4.2	-4.6	-4.7
Budgetary Balance – Baseline Scenario	**-90.2**	**-36.4**	**-30.6**	**-25.4**	**-14.5**	**-3.4**	**4.5**
Fiscal impact of downside economic scenario	-	-12.7	-21.8	-16.8	-15.9	-15.3	-12.8
Budgetary Balance – Downside Scenario	**-90.2**	**-49.1**	**-52.4**	**-42.3**	**-30.4**	**-18.6**	**-8.3**
Baseline Scenario							
Budgetary Balance (per cent of GDP)	*-3.6*	*-1.3*	*-1.1*	*-0.9*	*-0.5*	*-0.1*	*0.1*
Federal Debt (per cent of GDP)	*45.5*	*42.3*	*42.2*	*41.6*	*40.4*	*38.9*	*37.3*
Downside Scenario							
Budgetary Balance (per cent of GDP)	*-3.6*	*-1.8*	*-1.9*	*-1.5*	*-1.0*	*-0.6*	*-0.3*
Federal Debt (per cent of GDP)	*45.5*	*43.0*	*44.5*	*44.1*	*43.2*	*42.0*	*40.6*
Budget 2022 Projections							
Budgetary Balance (per cent of GDP)	*-4.6*	*-2.0*	*-1.4*	*-0.9*	*-0.6*	*-0.3*	-
Federal Debt (per cent of GDP)	*46.5*	*45.1*	*44.5*	*43.8*	*42.8*	*41.5*	-

Note: Totals may not add due to rounding.

[1] Provision of $8.5 billion over six years, for pressures that are anticipated to materialize in the near term.

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